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Phibro Animal Health Corporation (PAHC)

Q1 September 2016 Earnings Call



CORPORATE PARTICIPANTS

Richard Johnson *Phibro Animal Health Corporation - CFO*

Jack Bendheim *Phibro Animal Health Corporation - CEO*

CONFERENCE CALL PARTICIPANTS

Erin Wilson *Credit Suisse - Analyst*

Brandon Folkes *Guggenheim Securities LLC - Analyst*

Kevin Kedra *Gabelli & Co. - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Phibro first-quarter financial results call.

(Operator Instructions)

I would now like to turn the conference over to Richard Johnson. You may begin.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Good morning, everyone. Thank you, operator.

Welcome to the Phibro Animal Health earnings call for our first-quarter ended September 2016. On the call today is Jack Bendheim, our Chief Executive Officer; and myself, Richard Johnson, Chief Financial Officer. We'll provide an overview of our quarterly results and then we will open the line for your questions.

Before we begin, let me remind you that the earnings press release and financial tables can be found on the Investor's section of our website at PAHC.com. We are also providing a simultaneous webcast of this morning's call, which can be accessed on the website as well. Today's presentation slides and a replay and transcript of the call will also be available on the website later today.

Our remarks today will include forward-looking statements and actual results could differ materially from those projections. For a list and description of certain factors that could cause results to differ, I refer you to the forward-looking statements section in our earnings press release.

Our remarks today will also include reference to certain financial measures which were not prepared in accordance with Generally Accepted Accounting Principles, or US GAAP. I refer you to the non-GAAP financial information section in our earnings press release for a discussion of these measures.

Reconciliations of these non-GAAP financial measures to the most directly comparable US GAAP measures are included in the financial tables that accompany the earnings' press release. With that out of the way, let me turn it over to Jack Bendheim for some introductory comments. Jack?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Thank you, Dick, and thank you to all for joining us on this call this morning. Our first quarter was a solid quarter financially, and in my opinion even stronger operationally. As I noted in the press release, our core animal health segment achieved 4% growth in revenue and in adjusted EBITDA despite the significant headwinds we faced.



Some of the headwinds were cyclical in nature, the continuing weakness in the global dairy industry and the struggles of the Brazilian ag economy due to a combination of currency, input costs, and reduced domestic demand. Frankly we view these cycles as opportunities for us to gain share relative to others in the marketplace, share that will show itself as gains once these markets rebound as they inevitably will do.

The other challenges we are facing is the consumer-led transition in the United States away from antibacterials in food production. As we have previously discussed, this transition has been faster and more aggressive than the regulatory-led transition that we had anticipated occurring at the end of this calendar year.

We view this as a long-term challenge in the US demand for certain of our MFAs and we have taken and will continue to take our lumps in this market. Despite these challenges, the double-digit sales growth of our nutritional specialty and vaccine offerings shows that we have the products and the people to help our customers transition to new solutions for the health of their animals.

While we have not achieved a one-to-one replacement across our US customers, our conversion rate is increasing, and in the coming months and years we are poised to reach new heights in our business. I look forward to taking your questions today in this presentation. I now will pass this back to Dick to go over our financial results in greater detail.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

Thanks, Jack. Let me briefly walk us through the numbers. On page 4 let's first review the consolidated results for our September first quarter.

Consolidated sales were \$188 million for the quarter, approximately a \$1 million increase over the same quarter last year. The sales increase was driven by volume growth in the Animal Health segment. Mineral Nutrition net sales were below last year on lower commodity pricing driven by the underlying reduction in input costs.

Gross profit was 32.4% of sales, and that was an improvement of 80 basis points compared with last year, or a \$1.8 million increase up 3% over last year. The improvement was due to favorable business and product mix, volume growth, lower raw material costs, and improved operating efficiencies as we continued to see the benefits of recent CapEx investments.

Selling, general, and administrative expenses increased \$1.8 million, or 5% on a reported basis. The current year included \$1.3 million of costs related to the evaluation and negotiation of a potential acquisition that ultimately was not successful. We've excluded these costs from adjusted EBITDA as an unusual item and consistent with our practice of excluding acquisition-related items. We will not have any further comments on this attempted transaction. SG&A included in adjusted EBITDA grew 2%, or \$600,000, without the acquisition-related costs. The Animal Health segment accounted for about \$400,000 of that growth.

Adjusted EBITDA was \$29.8 million, a \$2 million or 8% increase over the prior year as all segments of the Company contributed to the profit improvement.

Adjusted diluted EPS was \$0.36 a share, a \$0.02 per share increase or 6% growth over last year. The sales growth and volume improvements which drove improved gross profit was partially offset by SG&A growth. The effective tax rate was 32.4%, approximately 1 percentage point higher than last year.

Looking now more closely at the Animal Health business on page 5, sales in the segment of \$124.5 million grew more than \$4 million or 4% over last year. The growth was driven by double-digit increases in nutritional specialties and vaccine product groups which offset a decline in the MFAs and other category. Nutritional specialty product sales of \$26 million grew almost \$4 million or 18% over last year on volume growth of products used by dairy and poultry producers.

Vaccine sales of almost \$15 million grew \$2.5 million or 21% over last year on volume growth across the product portfolio and including products acquired from MVP in January 2016. Sales of MFAs and others were approximately \$83 million in the quarter, a \$2 million or 2% decrease from last year. We saw reduced sales of medically important antibacterials in the US, however, we did see growth in other domestic products.



We saw international sales decline slightly due to a sales decline in Brazil resulting from challenging economic conditions with growth in other regions providing a partial offset. Adjusted EBITDA for this segment of \$32.6 million increased \$1 million or 4% over last year. The gross profit growth was partially offset by a modest increase in operating expenses.

Now looking at our other segments on page 6, Mineral Nutrition net sales of approximately \$51 million declined \$3 million or 5% from last year as we saw stable volumes offset by lower commodity pricing. Segment adjusted EBITDA of \$4 million was a solid increase of \$800,000 over the prior year on the benefits of lower raw material costs and reduced operating expenses compared with last year.

Performance Product net sales of approximately \$12 million were slightly below last year, but favorable product mix and input costs drove a \$700,000 improvement in adjusted EBITDA. Corporate expenses of \$7.5 million increased \$0.5 million year over year on increased compensation and benefit costs.

Turning to page 7 and capitalization and capital allocation, our leverage ratio of debt to trailing-12 adjusted EBITDA was 3 times at the end of the quarter. That's a sequential improvement from the June 2016 level of 3.1 times as we generated cash and reduced debt in the quarter. We had \$37 million of cash on the balance sheet at quarter end.

For the quarter we generated approximately \$16 million of net cash flow before financing. Working capital needs were neutral in the quarter, a substantial improvement compared with last year.

CapEx used approximately \$6 million of cash in the quarter, and we maintain our full-year CapEx guidance of \$30 million. We paid a routine quarterly dividend in the quarter and have declared the same amount per share to be paid in December.

Finally on page 8 we have repeated our guidance for your convenience. We have reaffirmed our annual guidance that we presented in our late August press release. There have been no changes to these numbers from what we discussed at that time.

So that's the conclusion of my prepared remarks. Operator, if you would please open the line for questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Erin Wilson, Credit Suisse.

Erin Wilson - Credit Suisse - Analyst

Great, thanks for taking my questions. What would you say is the underlying organic growth rate across your Animal Health segment in the latest quarter, excluding MVP? And also more broadly how should we think about the organic growth profile over the next three to five years?

Can you also speak to the acquisition you were referring too I think in your prepared remarks? Did this have an impact on the quarter or what was the timing and magnitude in terms of material contributions to that? Thanks.



Jack Bendheim - *Phibro Animal Health Corporation - CEO*

I will take a first crack at the acquisition, which is that we said in our prepared remarks we're not going to comment on the acquisition that we were unsuccessful in doing. We did state in our numbers that we took an SG&A hit in the quarter. And beyond that it didn't contribute anything positively other than expenses and time spent.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

I would say organic growth rate is not significantly affected by the MVP acquisition, Erin, and I would point you to our guidance for Animal Health segment sales -- sorry, we are calling for 2% to 5% sales growth in the Animal Health segment. And I think that's fundamentally an organic growth rate as it reflects the mix of the double-digit growth in nutritional specialties and vaccines with weakness in the MFA category.

Erin Wilson - *Credit Suisse - Analyst*

Okay, great. Then can you just comment on current fundamental utilization trends across the Animal Health business, depressed poultry, swine, and the dairy markets broadly speaking? Thanks.

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Broadly speaking as we're saying I think everyone is seeing the dairy markets remain weak. Pricing has not recovered. Where pretty much it is been the past 18 months already when we've been in the bottom of that cycle. I think the other markets seem fairly healthy.

I don't think a lot of our customers are making a ton of money on the pork side, but on the poultry side I think they seem to be doing well and volumes remain strong. Again, we answered the question here on the east coast of the United States, we're talking about a global business and across the markets as we had said earlier Brazil is weak across all segments.

China is in and out on some segments and it is a quite dynamic world. But overall tied to the general theme we see growth across the world.

Erin Wilson - *Credit Suisse - Analyst*

Great, thanks so much.

Operator

Brandon Folkes, Guggenheim Securities.

Brandon Folkes - *Guggenheim Securities LLC - Analyst*

Hi, thanks for taking my questions. Just following on from that last point. Could you give us a bit more detail on the international regions that are growing and where you see opportunity for growth going forward?

I know there has been a lot coming out of swine in China recently and how that's moving to a more sophisticated market. And then secondly just an update on the vaccines plans, if that's now complete? Then lastly, just any color on the erosion in the MFA business?

I think this has slowed. Do you think we are through the FDA erosion, now it's just consumer erosion? Then lastly I see you invested behind -- you have some sales force expansion. Just any color and what segment that is in? Thank you.



Jack Bendheim - *Phibro Animal Health Corporation - CEO*

We got to all five fingers on my hand. If I can remember correctly and just taken in any order. We continue to invest in sales force expansion in different regions. So we have continued to invest in the far east and talking about that, that is the region where we are seeing growth.

Generally speaking we are seeing in the subcontinent of Asia we are seeing growth, we're seeing specific markets growth in poultry, even growth in the dairy industry in those submarkets. Regarding MFAs, I think it is now -- we are in November. We are past the election so any affect of the regulatory changes in MFA I think we have seen that affect.

I think what we are starting to see, as both Dick and I mentioned, or what we continue to see is the consumer effect. And I think that will continue for a while. It will continue until that market is satisfied, or it will continue until we see customers having the inability to raise animals without the admission of antibiotics because as we get into more difficult weather conditions these animals do get sick. Sorry, my memory is gone on the last two.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

One of them was the Beit Shemesh plant, which is our vaccine production plant. And yes, it is back up fully in production. Has been for several months now.

So we are still recovering some business with certain customers where we had out of stock situations before, but on the production side we are running fine. No problems there. That's the only other one I had down, Brandon, what else was there?

Brandon Folkes - *Guggenheim Securities LLC - Analyst*

I think that's it. You covered it all. Just perhaps maybe just elaborating on that vaccines, and then how much of the vaccines growth in the quarter was the redirection to Europe compared to lower margin regions we've seen in the past? And then that's me. Thank you.

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Again, our sales in Europe remain very, very small. We have some regulatory permission. The regulatory changes we had done at that plant in Israel was to comply with European regulations, but mostly for our sales in Turkey and in Poland.

So those are where our sales are, and clearly those markets are not as large as the markets in historic Europe. The growth is coming from the rest of the world and growing from our sales of vaccines in the United States.

Brandon Folkes - *Guggenheim Securities LLC - Analyst*

Great, thanks very much.

Operator

(Operator Instructions)

Erin Wilson, Credit Suisse.

Erin Wilson - *Credit Suisse - Analyst*

Thanks. During the prepared remarks you mentioned I guess a better conversion rate or conversion rate increasing. Can you elaborate on the dynamic there? Thanks.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

What we are saying is as our customers would stop using antibacterials and in particular medically important antibacterials, they are looking for other products to help them maintain the health of their animals. So we think of it as a share of what they are spending on their animal health spending.

So as we see \$1 of sales go away from those antibacterials we are looking to convert that business over to either a nutritional specialty product or vaccines or a combination of the two. That's what we are talking about.

Erin Wilson - *Credit Suisse - Analyst*

Okay. Then if I think about -- are there other MFAs that they are switching to as well?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

There's a whole host of solutions, and I think as we've said so often no one uses antibiotics because that's the cheapest feed out there. People use antibiotics because it's the most effective product and gives them the best return.

So when the market is shifting away, when the consumer trend is I want to buy a piece of chicken that was never raised with an antibiotic so then you have to use different kinds of combinations. And it's still early in those days.

People are trying different products. I think we have a couple of products that are working well, and we will continue to add to that portfolio over time. But there's no one specific product.

Erin Wilson - *Credit Suisse - Analyst*

Okay. Then just going back to acquisitions, it sounds like you are at least trying to be active there. What does the pipeline look like right now?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

I don't think the pipeline is that full right now. We are out there, as you can tell by the numbers. We are reporting this past quarter of an unsuccessful attempt.

There are not that many sizable acquisitions in the Animal Health space available. So we will continue to look obviously for bigger deals. They seem to be best, but we will continue to look at smaller deals as well in various geographies.

Richard Johnson - *Phibro Animal Health Corporation - CFO*

I think we are looking either -- so for geographical expansion it would be more looking for probably a business, but we are also looking for individual product opportunities, and that those product opportunities fall mostly either into those two fast-growing categories, nutritional specialties or vaccines, where we are looking to add additional products to those portfolios.



Erin Wilson - *Credit Suisse - Analyst*

Could those be licensing deals, partnerships as opposed to outright acquisitions?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

Yes. I think these are not products that people have created specifically for animals, so we are looking across a spectrum. But there are successful products that work.

As we've always said in the past, one has to do a lot of testing on lots of animals to convince our customers that these products work. So it is not like feeding a couple of chickens in a backyard and then going to the marketplace. It takes time, it takes investment, but we are continuing looking to expand our portfolio.

Erin Wilson - *Credit Suisse - Analyst*

Okay. Great. Thank you so much.

Operator

Kevin Kedra, Gabelli & Company.

Kevin Kedra - *Gabelli & Co. - Analyst*

Hi, thanks for taking the question. Just wanted to know if you could talk a bit about pricing, whether you are seeing any opportunities in the pricing environment, especially on products that are being used as a substitution for MFAs and antibiotics and for animals that are meant to be antibiotic free?

Jack Bendheim - *Phibro Animal Health Corporation - CEO*

That's a great question, Kevin. Many of these products are new to the market, so it is not like -- it's not that we've had history in pricing, it is really as we bring these products to the market and as we invest in them it is finding the right market price in order to introduce these products. Because our customers demand that we do it right and that we do the safety testing, that we continue testing on enough animals.

So it is a learning experience for us. So far I think we're getting it right. But these are lots of new products and -- which we are looking at. It is not as simple as we've had these products in our portfolio let's just raise the price 2%, 3% a year. It's the right price to give the right return to our customers and the right return to our shareholders.

Kevin Kedra - *Gabelli & Co. - Analyst*

Great, thank you.

Operator

I'm showing no further questions. I would now like to turn call back to Richard Johnson for any further remarks.



Richard Johnson - *Phibro Animal Health Corporation - CFO*

All right, everyone, well we'll just say thank you and have a happy Thanksgiving, and we will be talking to you again in February. Take care until then. Bye now.

Operator

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may all disconnect. Everyone have a great day.

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